Economic Outlook

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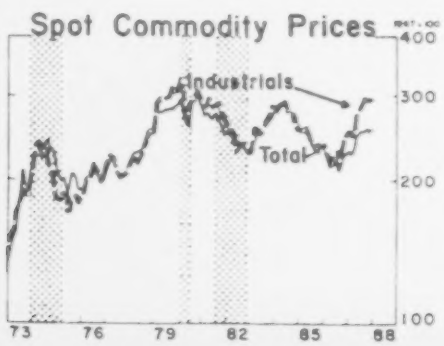
Once again the markets have been surprised by stronger-than-expected employment growth. The healthy increase in December employment coming on top of the gains in the prior two months just about guarantees that fourth quarter GNP grew at well over a 3% rate. Christmas sales showed only a modest gain from a year ago in line with the slowdown in retail sales which has been evident since mid-1987. There appeared to be little additional impact from the stock market decline in October. Strong employment growth and lower interest rates since October have apparently more than offset whatever negative effect the stock market crash exerted on consumer spending. Consumption growth is being sustained at moderate levels by continued income growth. Aided by these higher income levels, the latest index of housing affordability compiled by the National Association of Realtors rose to its highest level in 10 years. The index shows that the median-income household currently has over 15% more income than is necessary to buy a median-priced home with conventional mortgage financing. This should help sustain 1988 housing starts.

The purchasing managers survey taken in December also confirms the underlying vigor of the business sector, showing "no apparent ill effects" from October's stock market plunge. Slower delivery times, higher materials prices, shortages of key materials, stronger orders, and declining inventories all point to almost boom conditions in the industrial sector. The December survey reported the strongest growth in production since 1983. Some analysts have dismissed the strong fourth quarter output gain in the U.S. as reflecting excess inventory buildup. If true, this would eventually force a production slowdown, as the unwanted inventories are worked off. But the purchasing managers survey contradicts this view, with the managers reporting difficulty building inventories up to the desired level as orders continue strong.

In addition to the good news on the employment front, the inflation news has been reassuring in recent months. For the fourth quarter as a whole, the producer price index for finished goods was actually down a bit. Food and energy price declines helped to keep the index down in December. This respite from the evidence of building inflationary pressure last summer is unlikely to last much longer. The prolonged dollar depreciation, labor market tightness, and fuller utilization of industrial capacity all point to fundamental pressure for higher prices down the road. To date, the clearest evidence of building inflationary pressures is in industrial commodity prices. Here double-digit increases have accompanied the U.S. industrial rebound since late 1986.



While overall inflation is likely to pick up somewhat, it will be to levels far below the double-digit ranges of the late 1970s. Instead, we expect consumer price inflation to move from the 4%-4.5% range of 1987 into the 5%-5.5% range by late 1988. The bottom line is that any slowdown in the economy will be from the unusually high growth level of 1987's second half. While a deceleration from over 4% growth to the 3%-3.5% GNP growth range would be a slowdown, it would still represent an above-average increase for the U.S. economy. A more pronounced slowdown does not seem to be in the cards. Two recent trends seem to be behind what we believe is a mistaken consensus view that economic growth will fall below 2.5% in 1988. One is the recent more moderate growth of domestic demand; the other is the recent strength in inventories. While these changes may reduce growth a bit, they do not seem sufficient to cause a dramatic slowdown. Surging exports are offsetting much of the decline in domestic demand growth. Above-average capital spending increases will also be necessary to expand diminishing excess capacity in many parts of the industrial sector. Undesired inventory accumulation of some retail and auto products is at least partly counterbalanced by lower-than-desired stocks in other sectors. The current situation is similar to last January when most economists were overly pessimistic about the prospects for 1987 growth. The economy seems poised again to surprise the experts with another year of better-than-expected growth.

Robert T. McGee

Real GNP

(Percent Contribution to Real GNP Growth; Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986	1987			1987	1988			1985-	1986-	1987-
	IV	I	II	III	IV	I	II	III	1986	1987	1988
Consumer Spending	0.3	-0.5	1.2	3.5	0.0	0.8	0.8	1.0	2.7	1.3	1.0
Business Investment	0.6	-1.9	1.3	2.8	1.5	0.6	0.6	0.6	-0.3	0.2	1.1
Residential Investment	0.1	-0.4	-0.2	-0.4	0.0	-0.1	-0.1	-0.1	0.6	0.0	-0.1
Change in Inventories*	-0.1	4.4	-1.6	-1.5	0.6	0.8	0.5	0.2	0.0	0.2	0.2
Net Exports	1.1	1.8	0.3	-0.6	1.0	0.8	0.9	0.7	-1.0	0.3	0.6
Government Purchases*	-0.5	1.0	1.5	0.5	0.5	0.5	0.5	0.5	0.9	0.8	0.6
Real GNP	1.5	4.4	2.5	4.3	3.6	3.4	3.2	2.9	2.9	2.8	3.4

Quarterly Economic Indicators

(Percent Changes at Annual Rates)	Actual				Forecast				Actual	Forecast	
	1986	1987			1987	1988			1985-	1986-	1987-
	IV	I	II	III	IV	I	II	III	1986	1987	1988
Nominal GNP	2.1	8.6	6.3	7.3	7.7	7.9	8.1	8.4	5.6	6.0	7.8
GNP Deflator	0.7	4.2	3.5	2.8	4.0	4.4	4.9	5.3	2.6	3.0	4.4
Corporate Profits After Tax#	-0.3	6.7	10.0	9.0	6.3	12.5	10.1	8.5	-1.0	9.0	9.5

Monthly Economic Indicators

	Recent Data			Actual	Forecast	
	Oct.	Nov.	Dec.	1986	1987	1988
Consumer Price Index** (%)	0.4	0.3	n.a.	1.1	4.8	5.1
Industrial Production (%)	1.1	0.4	0.2	1.0	3.7	5.1
Retail Sales (%)	-0.9	0.1	0.7	5.5	3.4	3.4
Auto Sales (million units, a.r.)	9.2	9.8	10.9	11.5	10.3	9.8
Housing Starts (million units, a.r.)	1.52	1.64	n.a.	1.81	1.65	1.53
Unemployment Rate (%)	6.0	5.9	5.8	7.0	6.2	5.5
Merchandise Trade Deficit ($ bn., a.r.)	-211.6	-158.6	n.a.	-156.2	-171.0	-145.0

*Adjusted for CCC purchases. **Annual percent changes are December to December. January 19, 1988
#Quarterly data are year-over-year percent changes.
a.r.=annual rate F=Forecast